

Understanding Life Settlements and Other Secondary Market Transactions

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All over the country, insurance agents are approaching prospective clients over the age of 65 to help them either sell their existing life insurance policies for amounts in excess of their cash values, or to help their clients obtain “free” life insurance and either upfront payments of cash or the potential of revenue from sales of their policies at some specified time in the future. Frequently, these individuals will proceed with either or both of these transactions without an understanding of their economic, legal and tax ramifications. Likewise, financial advisors may lack the ability to distinguish among these transactions, let alone explain to their clients the associated benefits and risks.

This article attempts to demystify this burgeoning marketplace and help financial advisors understand that, like anything else, there is a right time and wrong time for their clients to get involved.

Life Settlements

In the mid-1990’s, investors became interested in purchasing life insurance policies covering individuals with an impaired life expectancy (generally between 2-15 years). These transactions became known as a Life Insurance Settlements (also referred to as a Life Settlements or Senior Settlements). This should be distinguished from the Viatical Settlements, which deal with policies on terminal insured with life expectancies of less than 2 years.

In the Life Settlement market, the typical insurance policies sought in the Life Settlement market are ones that were purchased with the intent to, among other things, protect one’s family or business, or pay for estate taxes, which are no longer needed or wanted, are unaffordable or not performing as anticipated, or are owned by a party with a desire for liquidity. Generally speaking, the insured looking to enter a life settlement has experienced a change in health or financial condition since the life insurance policy was purchased.

If the policy owner who encounters one of these situations owns a policy:

- that is over two years old,
- with a relatively low cash surrender value and annual premium obligation, and
- that covers the life of an individual over the age of 65 with a life expectancy less than originally projected by the issuing insurance carrier (this could arise due to changes in health or general increases in life expectancy over time),

then investors may offer an amount greater than the cash surrender value, but less than the death benefit to purchase the policy.

Once the owner and beneficiary change and the proceeds are paid to the seller, the investor has the on-going obligation to pay premiums until the insured dies. The investor then collects the death benefit.

While life settlements can be an excellent exit strategy for clients who were already destined to surrender or lapse their existing policies, life settlements are also a powerful tool to allow clients to refinance their insurance portfolios. In other words, clients may have the ability to leverage the sale of old policies in life settlements, and then use the sale proceeds to minimize or totally eliminate the on-going cost of replacement coverage, or to purchase more death benefit for an equivalent cost.

For example, a 69-year female client was paying \$35,000 of annual premium for a \$1.5 million Universal Life policy. Through a life settlement, the client received \$183,000 net after tax. Concurrently, the client was able to obtain \$1.5 million of replacement coverage at an annual cost of \$41,000. Though the client is paying \$6,000 of additional annual premium, the client intends to use a portion of the interest she will earn on the life settlement proceeds to fund this added cost.

Stranger Owned Life Insurance

In traditional life settlements, policies are already in existence before a decision is made with respect to their sale. However, in a transaction known as Stranger Owned Life Insurance (“SOLI”) (also known as Investor Initiated Life Insurance, Investor Owned Life Insurance, Non-Recourse Premium Financing or Wet Paper [Wet Paper is a policy sold at anytime during the 2-year contestable period]), a life insurance policy is originated with the primary intent of selling that policy to an investor either before or after the expiration of the 2-year contestable period. As an inducement to enter the transaction, clients are offered “free” insurance coverage and the potential receipt of revenue from the sales of their policies.

The ability to receive “free” insurance is accomplished through non-recourse or “partial” recourse premium financing in which a third party lender funds the policy taking no collateral other than the policy itself.¹ While the concept from the client’s perspective seems fairly simple and straightforward (ostensibly an upside with no cost and no risk), the reality is that these are sophisticated financing transactions with real risks and costs that have to be carefully reviewed and structured.

¹ Partial recourse involves the insured having some obligation with respect to a portion of the amount advanced by the lender/investor. These programs need to be examined closely because the nature of the recourse can vary dramatically from program to program.

The Issues and Risks

Life settlements can present a number of issues for practitioners of which a client needs to be aware. These issues are multiplied in SOLI cases and create a potential minefield for the client and his or her advisor.

Insurable Interest

An insurable interest has been defined as a close relationship between the insured and beneficiary of a life insurance policy. The easiest examples include a husband and wife, partners in a business, or a parent and child.

There are two simple questions one may ask when determining whether an insurable interest exists:

1. Do the beneficiaries of the life insurance policy need the death benefit?
2. Do the beneficiaries want the insured to continue living?

If the answer to both of these questions is “yes,” then it is safe to assume that an insurable interest exists.

The law in most states, such as Michigan, is that if an insurable interest exists at the moment a life insurance policy is issued, then an insurable interest always exists. For example, in a Life Insurance Settlement, a policy may have been taken out years earlier for spousal protection (i.e., an insurable interest exists). Even if the policy is sold to an investor who obviously does not have a “close relationship” with the insured and would desire that the insured pass away as soon as possible, an insurable interest still exists. Accordingly, under current law life settlements, in and of themselves, are not inherently problematic from an insurable interest perspective.

On the other hand, in a SOLI sale, the policy is purchased with the intent to sell it to an investor, not to protect someone with a close relationship to the insured, and after the sale, the new beneficiary would like to see the insured die as soon as possible. Hence, there is an argument that no insurable interest exists. Many programs attempt to deal with this through partial recourse loans, small initial payments by the original policy owner or arguments about the right of the original owner to “pay off” financing in the future and retain control of the policy. While there is no legal guidance on this issue, the legal departments of the major carriers have taken the position that one must look at the economic reality of the transaction. For example, if the partial recourse is structured to make the chances of enforcement by the lender minuscule or if the loan repayment terms are structured so that no reasonable person would ever retain the policy in the absence of a life threatening illness there is a serious question of insurable interest.

Here is the danger. Most SOLI contracts may provide the investor the right to go back against the original owner of the policy and/or the insured’s estate, if a death claim is successfully challenged by a carrier. In other words, if the investor expected to receive \$10 million upon the death of the insured and the carrier challenged the death claim on the grounds that no insurable interest existed, the investor could seek to recover \$10 million or the loss of its anticipated profit from the original owner and/or the insured’s estate. This is further complicated by the fact that non-contestability statutes on life insurance policies generally do not apply in the case of fraud.

Fraud

Life Insurance companies openly publicize the fact that they do not approve of SOLI and do not want their policies purchased for SOLI. Their main rationale is that, in the past, they expected a larger number of their policies to lapse or be surrendered before the insured died thereby avoiding the payment of a death claim. Now, however, once a life insurance policy is sold on the secondary market to an investor, that policy will be on the books until the insured dies and a death benefit will likely have to be paid.

In response to their concern, most life insurance companies have added a number of questions in their life insurance applications in an attempt to feel out whether the policy being purchased will be sold. Typical questions include disclosure of financing arrangements and disclosure of commitments or agreements to sell the policy in the future. In order to consummate most SOLI sales, an applicant may be coached by his or her agent to answer “no” to these questions. Some programs attempt to address this by putting the loan in place with the commitment to sell days or weeks after the insurance is placed. Regardless, failure to accurately answer these questions can be deemed fraud and there is a frequently a significant paper trail evidencing the client’s intent.

Again, if the contract between the investor and original policy owner provides recourse to the investor in the event of a successful challenge to the death claim – in this case on the basis of fraud - your clients could be at risk. In the last two years, New York Life and John Hancock have brought legal actions to challenge policies that were purchased for use in SOLI transactions. Clearly, the legal fees and costs that your clients could incur in such a lawsuit may pale in comparison to consideration they may have received in the transaction.

In those situations where insurance is purchased for business or estate planning purposes, it is still advisable to disclose on the application that the existence of the life settlement market has been discussed with the client as a matter of course consistent with the advisors fiduciary duty to his or her client. If for example, the client has significant financial difficulties and decides to sell the policy shortly after the contestability period ends (a legitimate use of the secondary market), it would be preferable to have disclosed to the carrier that the client could consider selling the policy in the future if their needs changed.

Lack of Future Insurability

Each individual who applies for life insurance has a maximum threshold of coverage that will be issued based on the size of their financial capacity and net worth, and the reinsurance capacity of the life insurance industry for an individual risk. For example, if an individual’s total insurability is \$20 million, and that individual already owns \$18 million of coverage, arguably no carrier will issue more than \$2 million more of coverage. The client must understand that in selling existing coverage they may be foreclosing additional coverage in the future. This is more of an issue where insurance is held and sold as an investment.

In order to maximize everyone’s gain in a SOLI sale, the parties want the largest possible policy to be issued. This has the effect of using up the insured’s maximum amount of insurability. If the insured’s financial situation changes after entering into a SOLI transaction and he or she desires to obtain more insurance coverage, there is a substantial likelihood that no carrier will issue more coverage because the insured is at capacity.

Tax Consequences

In looking at the tax consequences of a life settlement the starting point is calculating the basis in a life insurance contract. Under Sections 72(c)(1) and (e)(6) of the Internal Revenue Code the initial basis is derived from aggregate premiums paid. Additional premiums paid for supplementary benefits such as waiver of premium, double indemnity, accidental death protection and disability income are excluded from aggregate premiums paid. In addition, non-taxable distributions, such as cash dividends, dividends used to purchase riders or accumulate interest or for non-taxable withdrawals, are also subtracted from aggregate premiums paid in calculating basis.

It is important to be aware that in PLR 9443020, the Internal Revenue Service has taken the position that the cost of insurance protection (i.e., mortality charges) must be subtracted from basis. This has some lead some commentators to state that basis must be equal to cash value but this would not be true in the case of today's no lapse guaranty policies which often have no cash value but maintain so called "shadow" reserve accounts. More importantly, the position of the IRS appears to run counter to the Regulations under Section 72(e), as well as a series of appellate court cases in the early 1960's, including the Seventh Circuit's 1964 decision in Gallun v. Commissioner, 327 F2d 809 (1964). Nevertheless, this issue needs to be considered an open issue in determining the taxable gain.

The next issue is the characterization of any gain. Assuming a policy is sold for an amount in excess of its cash value, there is no question that the amount of gain represented by the excess of policy cash value over basis (if any) will be treated as ordinary income. The question is what about the gain in excess of such amount? The life settlement industry has argued that the proper characterization of the gain is as a capital gain. Fully addressing this issue is beyond the scope of this article. The central question, however, seems to revolve around whether a life insurance contract is considered a capital asset. Advocates for capital gains treatment point to a series of cases that are more than 50 years old that indicate life insurance contracts are capital assets. On the other hand, life insurance contracts' unique tax status under Section 101 of the Code would indicate that a blanket application of the rules applicable to capital assets is far from a forgone conclusion.

This issue is of critical importance to the preparer of the client's tax return, particular in light of the 2007 revisions to Section 6694 of the Code imposing penalties on return preparers for failing to meet certain standards in preparing tax returns. The CPA may be obligated to file a separate disclosure with the tax return (e.g., on Form 8275, Disclosure Statement, or Form 8275-R, Regulation Disclosure Statement, attached to the return).

One recommendation that can be made with regard to insurance policies purchased for estate planning purposes is that the advisor consider making the Irrevocable Life Insurance Trust ("ILIT") an Intentionally Defective Grantor Trust ("IDGT"). For a high net worth family, it will generally make sense to have the income taxes (regardless of characterization) associated with a life settlement paid by the grantor rather than the trust. By maximizing the assets in the ILIT that can be reinvested and redeployed, the estate planning benefits of the life settlement can be maximized. In many states, an existing ILIT can be merged into an IDGT with identical terms prior to the consummation of a life settlement provided the planner allows sufficient time to make the change and notify the carrier.

When SOLI is involved, the tax issues become significantly more complex. First, how will the IRS treat the money lent to the original owner to bind the policy? There is a question with any SOLI transaction as to whether the IRS will accept the payment of the initial premium as a loan as contemplated by the parties. Some commentators have suggested that the IRS split dollar regulations

could apply to these transactions resulting in the assessment of economic benefit tax liabilities to the insured. If non-recourse or limited recourse financing is used in a SOLI transaction and the policy is not sold at the end of the loan term but merely transferred back to the lender, there is a question of forgiveness of indebtedness income. The argument is often made that since the policy is held in an ILIT, any income tax liabilities will be trapped in an ILIT with no assets effectively insulating the grantor. One may question the extent to which the Service may employ a sham transaction argument to pierce a trust that never had net assets, particularly in those situations where the grantor is a partial guarantor of the indebtedness.

There has also been a suggestion that many SOLI transactions, particularly those which involve cash upfront payments to the insured, can be viewed as the purchase and sale of an option on an insurance policy. Under this theory, any upfront payment along with amounts “loaned” to pay the initial premium could be deemed an option payment. If the IRS were to pursue this theory, the amount subject to tax could greatly exceed the proposed upfront payment to the insured. Moreover, the option theory also calls into question whether the transaction is subject to the securities law.

Many SOLI transactions are supported by legal opinions from prominent law firms. These opinions need to be reviewed carefully by a client’s advisors as most are heavily reasoned opinions that support their ultimate conclusion as “more likely than not” accurate. The client, in most cases, cannot assume that the legal opinion replaces an independent assessment of the tax consequences of the transaction.

Ownership Concerns

Throughout this article, the secondary market purchaser has been referred to as the “investor.” But, who is the investor? The short answer is: “It depends.”

In life settlements, an overwhelming majority of policies are purchased by large institutional investors. These include hedge funds, pension funds, private equity firms and investment banks. It has become common practice for these investors to pool a large number of policies together (a pool typically consists of over 100 policies) and either maintain ownership of the pool or sell it to another investor on the secondary market. In fact, one of the rights granted to the original investor is the ability to resell the policy. Once resold, the new owner has the same right to hold the policy or resell it to yet another investor.

The risk here is lack of control over who owns the policy. While it is uncommon, it is theoretically possible that institutional investors can resell individual policies or entire pools to private investor groups. Due to their sheer size and diversification among investor assets, an institutional investor, like Bear Stearns, has significantly less financial risk if insureds live longer than anticipated. Due to the law of large numbers, if Bear Stearns owns 10,000 policies, for every 100 insureds that may live longer than anticipated, there are 100 insureds that are going to die sooner than anticipated. Either way, Bear Stearns is going to have an average IRR that it can expect from its life settlement pools. On the flip side, a group of private investors that may own only a limited number of policies have significantly more financial risk if insureds live too long.

Now ask yourself this question: Would you want to be the insured under a life insurance policy owned by an individual who can no longer afford to pay premiums and who has already invested millions of dollars into your policy?

There are two things that policy owners can do to maintain some level of control over who owns their policies. First, perform due diligence on the initial buyer. Inquire whether this is an institutional buyer, whether this buyer traditionally holds the policies it buys or whether it resells them as a practice, whether policies are resold to other institutions or to private investors, and whether the principals of the investor have any securities or criminal records. Second, attempt to include a provision in the life settlement contract that provides the policy owners the right to be notified in advance of their policies being resold. The notification should indicate the identities of the new owners and the dates upon which the sales will take place.

Changes in the Law

SOLI, in particular, has drawn the attention of certain Congressional leaders and regulatory bodies. In the past several years, the New York Attorney General's Office has issued an opinion questioning the legality of certain SOLI transactions under the state's insurance laws. The insurance industry is on notice from Congress that SOLI and potential abuses of insurance related thereto are on the Congressional radar and that the industry should take steps to eliminate potential abuses. In 2007, the National Association of Insurance Commissioners (NAIC) issued the Investor Initiated Life Insurance Prevention Amendments to the Viatical Settlements Model Act.² These Amendments do not eliminate SOLI but impose a 5 year waiting period before a SOLI policy (as defined in the Model Act) can be sold pursuant to a life settlement. These Amendments are being reviewed by a number of states but have not become law in any state as of the date of this article. For advisors, the key issue here is that the assumed benefits of a two year financed transaction could prove to be illusory if the Model Act is adopted in the applicable jurisdiction. The documentation for many SOLI deals contains a change of law provision which could make the note fully recourse to the client.

Fulfilling Fiduciary Obligations

It is well known that financial advisors owe a fiduciary obligation to their clients to do what is in their best interest. If a financial advisor is asked to get involved in any aspect of a life settlement or SOLI transaction, there several basic steps that can be taken to help protect a client's best interest.

First, at the heart of any transaction is a life insurance policy. A life insurance policy is a complex financial instrument that is structured differently depending upon policy type, premium obligation, crediting rate, etc. A financial advisor would be well served aligning with an expert in life insurance so that a proper analysis of the policy can be performed before it is sold. At the same time, an expert in life insurance can help determine whether an insured would have additional insurable capacity once the policy is sold in the event that the insured may need to buy more life insurance in the future.

² See http://www.naic.org/documents/committees_a_LSI_amendments.doc

Second, the advisor should review with the client the risks associated with the particular transaction. Typically, these risks are outlined in writing in the application paperwork. However, if no disclosures are contained in the initial paperwork, an advisor could call the State Insurance Commissioner or the Life Insurance Settlement Association to obtain the relevant information.

Third, the advisor and client should be aware of the identity all potential buyers of the policy, the amount of any offers or counter-offers, and the amount and method of calculation of compensation for any agent or broker involved in the in the sale. Moreover, in order to maximize competition for the sale, the advisor should ensure that the policy is receiving a sufficient amount of market exposure (e.g., the policies are sent to at least 5 institutions for their evaluation).

Fourth, advisors should help clients understand any post-sale obligations. These may include the payment of taxes, the duty to sign additional documentation in order to facilitate the resale of the policies, and the duty to keep the new owners reasonably informed of the insured's medical conditions when inquiries are made.

Conclusion

Life settlements and SOLI appear as relatively simple financial transactions. Yet, each has its own set of complexities that should be understood by financial advisors and clients prior to any significant involvement in the marketplace.

A life settlement can be a fantastic exit strategy to an unneeded or unwanted life insurance policy, or as an effective business and estate planning tool. But, life settlements have unique tax challenges, may prevent an insured from obtaining additional life insurance, and, if used in the wrong situation, may deny a significant amount of proceeds from insuring to policy beneficiaries. The life settlement process is complex and certain steps should be taken to ensure that the policy is competitively shopped and sold only to experienced institutional investors in this arena.

SOLI presents even greater challenges to clients and advisors. SOLI stretches the insurable interest requirement, as policies are being originated for the primary purpose of selling them to investors and not for traditional insurance purposes. The concept of "free" insurance may only be applicable if the policy is actually sold to investor in lieu of it being turned over to the lender as collateral for the loan. Again, the latter event may trigger payment of a tax due to the forgiveness of indebtedness, thus making the transaction no longer "free." In addition, because life insurance companies disfavor SOLI and ask questions on their applications regarding such programs, clients may be encouraged to lie in order to secure their policies. If these lies are later determined to be fraud by the insurance companies, clients may become liable to the investors stuck holding the policies that will no longer pay death benefits.

Life insurance is an important financial asset and it is the best interests of clients and financial advisors to have all of the facts before entering into any secondary market transaction.

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